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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 1138

RICHARD H. DUNNING and BEULAH MARIE DUNNING,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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INDEX

Citations to Opinions Below 2
Jurisdiction 2
Question Presented 2
Statutes Involved 2
Statement 3
Reasons for Granting the Writ 6
Conclusion 15
Appendix A—Statutes A1
Appendix B—Opinions and Judgment Below A3

Citations

CASES:

Atlas Oil Refining Corporation v. *Commissioner*, 36 T.C. 675 (1961) 9

Bazley v. *Commissioner*, 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782 (1947) 13

City Farmers Trust Co. v. *Irving Trust Co.*, 299 U.S. 433, 57 S. Ct. 292, 81 L. Ed. 324 (1937) 8-9

Commissioner v. *Duberstein*, 363 U.S. 278, 80 S. Ct. 1190, 4 L. Ed. 2d 1218 (1960) 14

Commissioner v. *Phipps*, 336 U.S. 410, 69 S. Ct. 616, 96 L. Ed. 771 (1949) 11

Commissioner v. *Sansome*, 60 F.2d 931 (2d Cir. 1932), *cert. den.* 287 U.S. 667, 53 S. Ct. 291, 77 L. Ed. 575 (1932) 11

Copease Mfg. Co. v. *American Photocopy Equipment Co.*, 298 F.2d 772 (7th Cir. 1961) 15

Elyria-Lorain Broadcasting Co. v. *Lorain Journal Company*, 298 F.2d 356 (6th Cir. 1961) 14

San Antonio Transit Co. v. *Commissioner*, 30 T.C. 1215 (1958) 9

Seiberling Rubber Co. v. *Commissioner*, 169 F.2d 595 (6th Cir. 1948) 9

United States v. *El Pomar Investment Company*, 330 F.2d 872 (10th Cir. 1964) 7, 9

United States v. *Kavanagh*, 308 F.2d 824 (8th Cir. 1962) 7, 14

United States v. *Snider*, 224 F.2d 165 (1st Cir. 1955) 7, 9, 10, 11

Western Massachusetts Theatres, Inc. v. *Commissioner*, 236 F.2d 186 (1st Cir. 1956) 9

STATUTES:

Section 77B of Chapter VIII, Bankruptcy Act of 1934, ch. 424, §1, 48 Stat. 912 (as amended) 4, 8, 9

Int. Rev. Code of 1939, §112(b)(10), added by Revenue Act of 1943, ch. 63, 58 Stat. 21 (1944) 2, 8

Int. Rev. Code of 1954, §316 (a), ch. 736, 68A Stat. 98 (1954), 26 U.S.C.A. §316(a) 2, 12, 15

Int. Rev. Code of 1954, §371(a)(1), ch. 736, 68A Stat. 121 (1954), 26 U.S.C.A. §371(a)(1) 2, 8

MISCELLANEOUS:

1 Merten's Law of Federal Income Taxation, Section 9.27, Rev. Ed. (1962) 13

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Richard H. Dunning and Beulah Marie Dunning pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above-entitled case on December 22, 1965.

CITATIONS TO OPINIONS BELOW

The opinion of the District Court, printed in Appendix B hereto, *infra*, p. A3, is reported at 232 F. Supp. 915 (W.D. Mo. 1964). The opinion of the Court of Appeals for the Eighth Circuit is as yet unreported and is printed in Appendix B hereto, *infra*, p. A27.

JURISDICTION

The judgment of the Court of Appeals (Appendix B, *infra*, p. A39) was entered on December 22, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Whether an accumulated deficit in the earnings and profits account of a corporation may be permitted to survive its reorganization in bankruptcy and to be recognized as offsetting earnings and profits realized by the successor corporation subsequent to such reorganization.

STATUTES INVOLVED

The statutory provisions involved are Section 112(b)(10), Internal Revenue Code of 1939, added by Revenue Act of 1943, ch. 63, 58 Stat. 21 (1944); Section 316(a), Internal Revenue Code of 1954, ch. 736, 68A Stat. 98 (1954), 26 U.S.C.A. § 316(a), Section 371(a)(1), Internal Revenue Code of 1954, ch. 736, 68A Stat. 121 (1954), 26 U.S.C.A. § 371(a)(1). They are printed in Appendix A, *infra*, p. A1.

STATEMENT

Petitioners are shareholders of Missouri Public Service Company, a Missouri corporation (¶4, R. 8). In 1958, 1959 and 1960 they received distributions with respect to their stock which were reported in their federal income tax returns as taxable dividends and tax was paid thereon (¶¶ 5, 6, R. 9). Subsequently petitioners timely filed a claim for refund of income tax for each taxable year, and thereafter, when the claims were not allowed, filed suit in the District Court (¶8, R. 9). Because the suit arises under the internal revenue laws jurisdiction of the District Court was invoked under 28 U.S.C. Section 1346(a)(1).

In their claims for refund and before the courts below petitioners have asserted that the distributions to them in each taxable year were in part from sources other than the earnings and profits and that, to the extent they were from such other sources, the amounts thereof were not taxable as dividends but rather served to reduce the basis of the company's stock in the hands of petitioners. If petitioners are correct they are entitled to refunds. Respondent's position has been that all distributions to petitioners were from available earnings and profits, and are therefore 100% taxable as dividends, and that no refunds are due.

The District Court held for respondent and denied any refund. The Court of Appeals affirmed.

In each taxable year it is stipulated that distributions of the corporation exceeded its *current* earnings and profits (¶45, R. 22). It is petitioners' position that in each year the corporation had no *accumulated* earnings and profits which could have served as a source of distributions taxable as dividends.

The predecessor of the distributing corporation (which had the same name as the existing company) was organized as a Missouri corporation in 1926 (¶9, R. 9). It is stipulated that as of November 30, 1936, a deficit in earnings and profits had been accumulated amounting to at least $1,465,627.91 (¶39, R. 19).[1] Effective as of December 1, 1936, that corporation (hereinafter sometimes referred to as the "debtor") was reorganized under Section 77B of the Bankruptcy Act, ch. 424, § 1, 48 Stat. 912, as amended (¶24, R. 12). Thereafter, earnings and profits were realized by the corporation which succeeded to the assets and business of the debtor (¶40, R. 19). The successor corporation is to be identified with the corporation which made the distirbutions here considered (¶¶39, 40, 41, R. 19-20).

If, as contended by petitioners, the earnings deficit of the debtor carried through and is to be recognized after the 77B reorganization as offsetting the earnings and profits of its successor during the period subsequent to the 77B reorganization, the corporation making the distributions in question had no accumulated earnings and profits during the taxable years here involved.

Immediately prior to its reorganization, the debtor was (as to its common stock) a wholly owned subsidiary of Inland Power & Light Corporation (¶52, R. 24). At that time Inland was a wholly owned subsidiary of Commonwealth Light & Power Company (¶60, R. 26). Commonwealth, in turn, was a wholly owned subsidiary of Middle West Corporation (¶21, R. 11; ¶31, R. 16). The debtor, Inland, and Commonwealth were reorganized in consolidated proceedings under the jurisdiction of the District Court for the Northern District of Illinois (¶31, R.

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1. Petitioners contend that the deficit as of November 30, 1936, was $1,866,293.32 (R. 20).

16). Middle West was reorganized in bankruptcy in a separate proceeding before the same court (¶31, R. 16). Inland, Commonwealth and Middle West are for convenience referred to as the "parent" of the debtor corporation.

The capitalization of the debtor immediately prior to its reorganization consisted of secured bonds (principal amount $6,351,000) and voting preferred stock, both of which were held by the public, and common stock and approximately 1.3 million dollars of unsecured accounts and promissory notes, both the common stock and the accounts and notes being owned by the parent (R. 12-15, 24, 87, 154, 156). The preferred stock comprised 25% of the total voting stock (common and preferred combined) (R. 12). After the reorganization the capitalization of the successor corporation consisted of secured bonds (principal amount $4,445,700), common stock and common stock subscription warrants (R. 13).

The old secured bonds were exchanged for new secured bonds written down 30% in principal amount and the bondholders also received in the exchange 47.5% of the new common stock of the successor corporation (R. 13). The old voting preferred was exchanged for approximately 22.4% of the new common stock (R. 13-14) and the accounts and promissory notes were exchanged for approximately 30.1% of the new common stock (R. 14).

As a result of these exchanges those persons or entities which collectively held 100% of the prior equity interests in the debtor, i.e., the preferred stockholders with voting rights and the debtor's parent, collectively received 52.5% of the equity in the successor corporation. The balance of the common stock went to the bondholders.

The debtor's parent received, in addition to 30.1% of the new common stock, subscription warrants which would have enabled the parent, if the warrants had been exercised, to increase its holdings of common stock from 30.1% to more than 36% (R. 14, 16). The warrants were never exercised, however (probably because of the high exercise price), and expired by their own terms in the hands of the parent on December 31, 1939 (R. 16).

All the business and assets of the debtor were acquired and operated by the successor corporation, and all liabilities, including tax liabilities, excepting only the accounts and notes held by the parent (including accrued interest) and 30% of the old bond liability all of which were replaced by new common stock, carried over to the successor corporation (R. 11-12, 15). There was no investment of new capital, nor did any person or entity have an interest in the successor corporation which did not have an interest, as either creditor or shareholder, in the debtor (R. 12-15). A few changes in personnel occurred, but the business had essentially the same operating management both before and after the reorganization (R. 15-16, 159-171).

The District Court held that no portion of the earnings and profits deficit which was stipulated to exist as of November 30, 1936, could be carried over and recognized after the bankruptcy reorganization as offsetting the earnings of the successor corporation. The Court of Appeals affirmed.

REASONS FOR GRANTING THE WRIT

1. The question presented is of obvious importance in the administration of the federal bankruptcy and tax laws. Settlement of the question by this Court is plainly in the public interest since it is likely to be presented with

respect to corporate distributions to many thousands of taxpayers. Petitioners represent but one of approximately ten thousand shareholders of Missouri Public Service Company. More importantly, there are no doubt thousands of shareholders who have received or will receive distributions from other corporations which were, or whose predecessors were, participants in bankruptcy reorganizations. The status of those distributions will be subject to controversy until the question presented here is settled by this Court. Because the issue is the correct calculation of accumulated earnings and profits, the impact of the answer to the question presented is not limited to the taxable years here involved, but will or may affect distributions by similarly situated corporations for all future taxable years.

The Court of Appeals relied heavily upon its own earlier decision in *United States* v. *Kavanagh,* 308 F.2d 824 (8th Cir. 1962). Petitioners emphasized the decisions of the Tenth Circuit in *United States* v. *El Pomar Investment Company,* 330 F.2d 872 (10th Cir. 1964), and the First Circuit in *United States* v. *Snider,* 224 F.2d 165 (1st Cir. 1955).

While in the instant case the court stated (Appendix, *infra,* p. A38) that it is not laying down any "absolute rule" regarding bankruptcy reorganizations, the court also stated elsewhere in its opinion (Appendix, *infra,* p. A34) that "The *El Pomar* court distinguishes our *Kavanagh* case, pointing out that the reorganization before it was carried out voluntarily, whereas the *Kavanagh* reorganization took place in a 77B proceeding." Approval of that distinction by the court below makes the tax treatment of an earnings deficit turn on whether or not the transaction occurred in the course of a federal bankruptcy

proceeding as distinguished from other available statutory or non-statutory procedures. Petitioners do not believe that this is or should be the law.

To the extent that Congress has spoken at all in the revenue laws on the subject of insolvency reorganizations (exclusive of railroad reorganizations), its expressions are found in Section 112(b)(10) of the Internal Revenue Code of 1939 (enacted as a part of the Revenue Act of 1943, ch. 63, 58 Stat. 21 (1944)), and Section 371 of the Internal Revenue Code of 1954 (both statutory provisions cited are set out in pertinent part in the Appendix, *infra*, p. A1). Both sections accord the same tax-free treatment to a "receivership, foreclosure, or similar proceeding" as is accorded to a proceeding under Section 77B or Chapter X. Rather than insuring greater uniformity in tax consequences, as was intended by Congress, the view of the Court of Appeals will cause completely different consequences to flow from transactions which are essentially similar, with the result in each case being dependent upon whether or not advantage is taken of the federal bankruptcy act.

The view of the Court of Appeals penalizes corporations and their creditors and security holders who participate in bankruptcy reorganization. That result is not only illogical and unfair, but is unsupported by any provision of the bankruptcy or revenue acts and in fact is completely contrary to the intent of Congress in enacting the remedial provisions of Section 77B. This court has said, "The purpose of Section 77B was to facilitate rehabilitation of embarrassed corporations by a scaling or rearrangement of their obligations and shareholders' interests, thus avoiding a winding up, a sale of assets, and a distribution of the proceeds." *City Farmers Trust Co.* v. *Irving Trust Co.*, 299 U.S. 433, 438, 57 S. Ct. 292, 294-295,

81 L. Ed. 324 (1937). Application of the view of the Court of Appeals would frustrate and defeat the remedial objectives of 77B by causing bondholders, creditors and participating shareholders to withhold the consents requisite to consummation of plans to preserve going business and thus would encourage the liquidation of businesses and the sale of their assets "on the block."

Petitioners believe that the survival or elimination of an earnings deficit is to be determined by reference solely to the capital and other changes which occur in a reorganization. Whether those changes occur in a bankruptcy proceeding or by some other means is irrelevant and this Court is urged so to hold.

2. If, as contended by petitioners, the fact that the reorganization here occurred in bankruptcy does not serve as sound or valid justification for the difference in results as between this case, on the one hand, and the *El Pomar* and *Snider* cases, *supra,* on the other, then an irreconcilable conflict exists between the Eighth Circuit and the Tenth and First Circuits.

The conflict between the Eighth and Tenth Circuits exists because the latter recognizes and applies the tests of continuity of ownership and continuity of business operations whereas the former does not.[2] In *El Pomar, supra,* these tests were held to have been satisfied and as a consequence an earnings deficit was held to survive two insolvency reorganizations.

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2. The tests are also widely recognized in reorganization and bankruptcy cases not involving earnings and profits. *Seiberling Rubber Co.* v. *Commissioner,* 169 F.2d 595 (6th Cir. 1948); *Western Massachusetts Theatres, Inc.* v. *Commissioner,* 236 F.2d 186 (1st Cir. 1956); *San Antonio Transit Co.* v. *Commissioner,* 30 T.C. 1215 (1958); *Atlas Oil Refining Corporation* v. *Commissioner,* 36 T.C. 675 (1961). These cases refine and develop the earlier continuity test referred to by the District Court, Appendix, *infra,* pp. A18-A19.

In the instant case there was simply a capitalization of debt into equity. No creditors were paid in cash. To the full extent that debt was reduced or extinguished there was but merely an exchange of debt for another type of continuing interest (common stock) in the debtor. Other liabilities, not exchanged for or replaced by common stock, were carried over and assumed by the successor corporation. No assets were sold or distributed or otherwise disposed of. Not one cent of new capital was invested. Substantial continuity of management was preserved. All shareholders of the debtor participated in the reorganization and became shareholders of the successor. The largest single shareholder of the debtor (i.e., its parent) was perpetuated in its dominant position. No person or group emerged from the reorganization having an interest in the corporation or its assets who did not have a prior interest either as creditor or stockholder. Here the tests of continuity of ownership and continuity of business operations were satisfied. The Tenth Circuit would permit the deficit carry-over.

Petitioners urge this Court to resolve the existing conflict.

3. Conflict exists also between the decision of the Court below and the decision of the First Circuit in *Snider, supra.* There a trust (taxable as a corporation) which owned and operated two hotels, reorganized itself into parent and subsidiary corporations each of which thereafter owned and operated one of the hotels. Stock of the parent was issued pro rata to the owners of the trust. It was held that an accumulated earnings deficit existing at the time of the reorganization was to be recognized as offsetting earnings and profits realized by the parent subsequent to the reorganization. The court so held because the reorganization had no tax avoidance purpose and the re-

sult of the carry-over was not to permit earnings and profits to escape dividend taxation which would have been so taxed had the reorganization not occurred.

In *Snider* the Court relied on *Commissioner* v. *Phipps*, 336 U.S. 410, 69 S. Ct. 616, 96 L. Ed. 771 (1949), wherein it was held that the deficits of five operating subsidiaries, following their liquidation, could not be subtracted from the parent's previously accumulated earnings and profits. In both *Snider* and *Phipps* the test applied was whether or not the fact of the reorganization itself or the manner in which it is structured creates the possibility or probability of tax avoidance. See also *Commissioner* v. *Sansome*, 60 F.2d 931 (2d Cir. 1932), *cert. den.* 287 U.S. 667, 53 S. Ct. 291, 77 L. Ed. 575 (1932). In *Phipps* that probability existed because the taxpayers sought to offset the deficit of one business against the already existent accumulated earnings of a different business. In the instant case as in *Snider*, however, the same business which had accumulated the deficit later realized the earnings, and the fact of the reorganization itself did not produce any possibility that earnings and profits could escape dividend taxation which would have been so taxable in the absence of the reorganization.

This Court is urged to determine whether it is the First Circuit or the Eighth Circuit by whom the proper test is being applied.

4. The Court below approved the theory (developed in the railroad reorganization cases cited by the Court, Appendix, *infra*, p. A35) that to permit the deficit carry-over would produce a "double benefit" in that the corporation escapes liability for its debts and the shareholders escape taxation by taking advantage of the former operating deficit. That argument is superficial and unsound for the following reasons:

1. It assumes that the shareholders, following the reorganization, will necessarily benefit from the opportunity to receive distributions out of capital. Such distributions, however, are not received "tax free" since they reduce the basis of shares upon which the distributions are made, thus increasing the taxable gain upon future distribution or corporate liquidation. Tax is not "escaped" but merely deferred.

2. When debt was reduced the bondholders and unsecured creditors of the debtor surrendered rights to receive approximately 3 1/4 million "tax free" dollars (in re payment of debt). The same persons received 77.6% of the new common stock carrying with it the mere possibility of receiving similar dollars if the deficit is carried over. The balance of the new common stock went to the holders of the old preferred who lost their preferred position. No second benefit is involved.

5. The Court of Appeals held that petitioners had failed to meet the "burden", purportedly imposed upon them, of overcoming a presumption that the distributions were from earnings and profits.

The Court, early in its opinion, quoted portions of Section 316 of the Internal Revenue Code of 1954 as follows:

> "* * * Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits * * *."

Apparently construing the quoted provision the Court stated (Appendix, *infra*, p. A30):

> "In order to escape dividend treatment as to the balance of the distributions, the burden is upon the taxpayers to show that the corporation had no accumulated earnings or profits from which the distribution could be made. * * * Taxpayers have failed to meet such burden."

That provision, however, does not create a true presumption, nor impose upon a taxpayer any corresponding burden, but rather states a rule of law. *Bazley* v. *Commissioner*, 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782 (1947); 1 Merten's Law of Federal Income Taxation, Section 9.27, Rev. Ed. (1962). It assumes by its terms the existence of earnings and profits, either current or accumulated. Until the existence of earnings and profits is established, which is the entire issue in the instant case, the rule (or "conclusive" presumption) of the statute is never reached and, in fact, is quite irrelevant. Thus, the rule of the statute is irrelevant in the case of a distribution made at a time when there is stipulated to be an earnings deficit. The statute does not create any presumption that earnings and profits exist, but merely states that a distribution is deemed to be from earnings and profits if they do exist, and, if so, "to the extent thereof".

That a "burden" is imposed upon petitioners is emphasized again at the close of the Court's opinion (Appendix, *infra*, p. A38) as follows:

> "The taxpayers have failed to meet the burden imposed upon them to show that any loss of earnings account remained after the reorganization which could be carried over."

This view led not merely to a result believed to be erroneous but, more importantly, led the Court to a self-imposed limitation upon the scope of its own review of the decision of the District Court, thus effectively depriving petitioners of that measure of review at the appellate level to which they are entitled as a matter of law.

All the facts were stipulated and as so stipulated were found by the District Court. The evidence was entirely documentary and no question of veracity or credibility of wit-

nesses was involved. Neither the District Court nor the Court of Appeals held specifically that petitioners failed to meet the burden imposed upon them at the trial level of going forward with the evidence to the extent necessary to overcome the presumption of correctness initially attaching to a determination by the Commissioner of Internal Revenue, or that petitioners failed to affirmatively prove all facts necessary for a correct calculation of their tax liability. This is not a case in which motives or intent are relevant factors. Compare *Commissioner* v. *Duberstein,* 363 U.S. 278. 80 S. Ct. 1190, 4 L. Ed. 2d 1218 (1960). In contrast to *Kavanagh, supra,* this is not a case where the record is unclear or incomplete, or where it is necessary to draw "inferences", as suggested by both Courts below (Appendix B, *infra,* p. A18 and p. A32) to arrive at the controlling facts.

It was stipulated that as of November 30, 1936, the debtor corporation had a deficit in earnings and profits of at least $1,465,627.91. As of December 1, 1936, the changes in capital structure occurred which constituted the reorganization. The facts as to those changes were likewise stipulated. The question for decision then became whether the capital changes caused the deficit to disappear. The Court of Appeals treated the question as a "fact issue" (Appendix, *infra,* p. A35) as to which the burden was on petitioners. Merely calling the question one of fact does not make it so. *Elyria-Lorain Broadcasting Co.* v. *Lorain Journal Company,* 298 F.2d 356 (6th Cir. 1961). Petitioners assert that the issue was not one of fact at all, but rather was one of what consequences flowed as a matter of law from the capital changes. As to that question no presumption of correctness attaches to the decision of the District Court and there is no corresponding burden imposed

on petitioners before the Court of Appeals. *Copease Mfg. Co.* v. *American Photocopy Equipment Co.*, 298 F.2d 772 (7th Cir. 1961).

Before the Court of Appeals petitioners argued that the decision of the District Court was based on an erroneous view of the law. As to the law, petitioners were entitled to appellate review unrestricted by any presumption of correctness. They were denied that review. The interests of large numbers of taxpayers will be adversely affected if this Court leaves standing a construction of Section 316 which imposes upon taxpayers in a dividend case any heavier burden than normally exists in any tax case. At the Court of Appeals level all appellants will be penalized if this Court permits any presumption of correctness to attach to the views of a District Court as to matters of law.

CONCLUSION

For the reasons stated, this petition for a writ of certiorari should be granted

Respectfully submitted,

ALBERT F. HILLIX
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Counsel for Petitioners

APPENDIX A

Int. Rev. Code of 1939, § 112 (b) (10), added by Revenue Act of 1943, ch. 63, 58 Stat. 21 (1944).

Section 112. Recognition of gain or loss—

(b) Exchanges solely in kind—

(10) Gain or loss not recognized on reorganization of corporations in certain receivership and bankruptcy proceedings. No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended) is transferred, in a taxable year of such corporation beginning after December 31, 1933, in pursuance of an order of the court having jurisdiction of such corporation—

(A) in a receivership, foreclosure, or similar proceeding, or

(B) in a proceeding under section 77B or Chapter X of the National Bankruptcy Act, as amended,

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.

Int. Rev. Code of 1954, § 316 (a), ch. 736, 68A Stat. 98 (1954), 26 U.S.C.A. § 316 (a).

Section 316. Dividend Defined

(a) General Rule—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year

without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Int. Rev. Code of 1954, § 371 (a) (1), ch. 736, 68A Stat. 121 (1954), 26 U.S.C.A. § 371 (a) (1).

Section 371. Reorganization in Certain Receivership and Bankruptcy Proceedings

(a) Exchanges by Corporations—

(1) In General—No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in Section 77 (m) of the Bankruptcy Act (49 Stat. 922; 11 U.S.C. 205)) is transferred in pursuance of an order of the court having jurisdiction of such corporation—

(A) in a receivership, foreclosure, or similar proceeding, or

(B) in a proceeding under chapter X of the Bankruptcy Act (52 Stat. 883-905; 11 U.S.C., Chapter 10) or the corresponding provisions of prior law, to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.

APPENDIX B

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF MISSOURI, WESTERN DIVISION

RICHARD H. DUNNING and BEULAH MARIE DUNNING,
Plaintiffs,
vs.
UNITED STATES OF AMERICA,
Defendant.
No. 13920-1

JOHN W. OLIVER, District Judge.

This action for a refund of income taxes paid was instituted pursuant to Section 1346(a)(1) of Title 28 United States Code. Full cooperative utilization of pretrial procedures enabled the parties to stipulate all the relevant facts. We state and paraphrase particular facts from that stipulation in order to place the questions for decision and the contentions of the parties in perspective. We, of course, find all the facts as stipulated.

STATEMENT OF FACTS

Missouri Public Service Company was incorporated as a Missouri corporation on November 29, 1926. On February 21, 1935, that corporation filed a petition under Section 77B of the Acts of Congress relating to Bankruptcy (C. 424, Section 1, 48 Stat. 912, as amended) in the United States District Court for the Northern District of Illinois.

A plan of reorganization was approved and confirmed by that Court on June 25, 1936. In the approved plan of reorganization, the existing corporate entity of the debtor

corporation, Missouri Public Service Company, was not utilized; a new corporation, Missouri Public Service Corporation, a Delaware corporation, was incorporated November 20, 1936, to effectuate the various provisions of that plan of reorganization.

On November 30, 1936, prior to the issuance of new securities and the transfer of assets provided for in the plan, the new corporation, Missouri Public Service Corporation, entered its appearance in the reorganization proceedings and consented and submitted to the jurisdiction of the United States District Court for the Northern District of Illinois.

As of November 30, 1936, immediately prior to the effective date of the reorganization of debtor Missouri Public Service Company, a majority of its capital stock having power to vote for the election of directors was owned by Inland Power & Light Corporation, all of whose capital stock having power to vote for the election of directors was then owned by Commonwealth Light & Power Company; Commonwealth Light & Power Company was then a wholly owned subsidiary of Middle West Utilities Company.

The securities of and claims against the debtor Company which were dealt with and adjusted under the Plan consisted of the following:

Designation	Number of Shares or Principal Amount Outstanding
Common Stock No Par Value	59,970 shares
$6 Cumulative Junior Preferred Stock No Par Value	1,286 shares
$7 Cumulative Preferred Stock No Par Value	18,677 shares

First Mortgage Twenty Year 5% Gold Bonds, Series A, due February 1, 1947	$6,351,000.00
Notes Payable (unsecured)	1,246,100.00
Accounts Payable (Purchase of Property)	102,214.69

In addition to the foregoing, additional unsecured claims against the Company were dealt with to the extent and in the manner hereinafter indicated.

The $1,246,100.00 unsecured notes payable were demand notes, the principal amount of which had remained constant since October, 1932. Those notes payable were held by Middle West Utilities Company.

The plan of reorganization provided for a capitalization of new Missouri Public Service Corporation as of December 1, 1936, the effective date of the reorganization, as follows:

Designation	Number of Shares or Principal Amount Outstanding
Common Stock No Par Value	133,705
Warrants for Purchase of 13,000 shares of Common Stock	13,000
First Mortgage Twenty-five Year 5% bonds, Series A, dated August 1, 1935 due August 1, 1960	$4,445,700.00

Pursuant to the approved plan of reorganization, securities of the new Missouri Public Service Corporation were issued and other adjustments were made as follows (references to "old" bonds, preferred stock and common stock, are to securities of Missouri Public Service Company and references to "new" bonds and common stock are to securities of Missouri Public Service Corporation):

(a) $700 principal amount of new bonds, dated August 1, 1935, were issued in exchange for each $1,000 principal amount of old bonds. By the terms of the plan said new bonds were to bear interest at 5% per annum from the date thereof, payable semi-annually on the first days of February and August. The first maturing interest coupon attached to the new bonds was due August 1, 1937. With respect to each $700 principal amount of new bonds cash of $52.50 was paid, said payment being denominated by the corporation as interest from the date of the bonds to February 1, 1937.

(b) One share of new common stock was issued to bondholders for each $100 principal amount of old bonds. Bondholders received a total of 63,510 shares of new common stock, 47.5% of the total number of new shares issued.

(c) One and one-half shares of new common stock were issued in exchange for each share of old preferred stock, irrespective of class. Holders of old preferred stock received 29,944.5 shares of new common stock, 22.39% of the total number of new shares issued as follows:

Old Securities Outstanding	Common Stock Issued
$6 Cumulative Junior Preferred Stock	
No Par Value—1,286 shares	1,929 shares (1.44%)
$7 Cumulative Preferred Stock	
No Par Value—18,677 shares	28,015.5 shares (20.95%)
Total	29,944.5 shares (22.39%)

(d) To the holder of the Notes Payable (unsecured) and Accounts Payable (purchase of property) and to the holders of certain other unsecured claims, were issued a total of 40,250.5 shares of new common stock, 30.11% of the total number of shares issued.

(e) The old common stock was exchanged for warrants, expiring December 31, 1939, entitling the holder (Inland Power & Light Corporation) to purchase an aggregate of 13,000 shares of new common stock at $25.00 per share.

In order to further identify the shifts of ownership caused by the execution of the plan of reorganization, it should be added that immediately prior to the effective date of the reorganization, December 1, 1936, all the common stock of the debtor Missouri Public Service Company was owned by Inland Power & Light Corporation but was pledged, as security for loans, to the Central Hanover Bank and Trust Company. The preferred stock of both classes and the first mortgage twenty-year 5% gold bonds Series A, due February 1, 1947, were held by the public.

As of December 1, 1936, the notes payable of the debtor corporation in the amount of $1,246,100.00 were payable to Inland Power & Light Corporation, but had been endorsed in blank without recourse by Inland and were then held by Daniel C. Green, Trustee for Middle West Utilities Company as security for the repayment of certain indebtedness due from The Commonwealth Light & Power Company to Middle West Utilities Company.

On November 30, 1936, the debtor Missouri Public Service Company transferred all of its property and assets to the new Missouri Public Service Corporation as provided in the approved plan of reorganization.

None of the stock purchase warrants were ever sold or exercised and all expired by their own terms in the hands of Inland Power & Light Corporation on December 31, 1939.

During the years 1958, 1959, and 1960 plaintiffs were the owners of shares of the common stock of the new Missouri Public Service Company, a Missouri corporation.

To avoid confusion of names, it should be added that effective May 31, 1950, the state of incorporation of the new Missouri Public Service Corporation was changed from Delaware to Missouri, and the name of the corporation was changed to Missouri Public Service Company. The name of the debtor corporation and the name of the presently existing corporation is therefore the same.

During the years 1958, 1959, and 1960 plaintiffs received from the new Missouri Public Service Company cash distributions with respect to the shares owned by them in the respective total amounts of $511.20, $548.46 and $827.28.

Those amounts were reported by plaintiffs on their income tax returns for the years involved as taxable dividends and plaintiffs paid income tax thereon.

Thereafter, and within the stztutory period of limitation within which claims for refund may be filed, plaintiffs filed a claim for refund with respect to each of the years involved. In each claim plaintiffs asserted that portions of the cash distributions were not taxable dividends but were distributions from sources other than earnings and profits and that with respect to each taxable year the amount from such sources was less than their adjusted basis for said stock.

There is no question but that as of November 30, 1936, Missouri Public Service Company had a deficit in earnings and profits at least in the amount of $1,465,627.91.

The parties expressly stipulated that "the major issue in this case is whether or not all or any part of this deficit should be carried over to Missouri Public Service Corporation of Delaware as of December 1, 1936, and then

taken into consideration in computing subsequent accumulated earnings and profits available for dividends in subsequent years."

Consequently, the parties also have expressly stipulated that "if no part of the deficit of the debtor Missouri Public Service Company as of November 30, 1936, is to be carried over beyond that date and the earnings and profits as of December 1, 1936, are to be considered zero, then all the distributions through the years, including the three years involved in this action, constitute taxable dividends."

CONCLUSIONS OF LAW

Plaintiffs' reply brief accurately summarizes the positions developed by the briefs of both parties. It is there stated: "The principal issue presented is whether or not a deficit in the earnings and profits account of [the debtor] Missouri Public Service Company as of November 30, 1936, immediately prior to the effective date of its bankruptcy reorganization, is to be carried over [to the new corporation] and recognized following the reorganization as an offset against earnings and profits realized subsequent to the reorganization. * * * Plaintiffs contend that the Company's reorganization was a tax-free reorganization under Section 112(g) (1) (E) and (F) of the 1939 Code, and, whether or not it was technically a tax-free reorganization, that the exchanges which occurred in 1936 were nontaxable exchanges under Section 112 (b) (5) of the Code. Defendant denies each of these contentions. Assuming the transactions to be nontaxable, the deficit carry-over is clearly required under the facts in the instant case because under that treatment of the deficit earnings and profits will be taxed as dividends to the same extent as they would have been so taxed had

no reorganization occurred. Defendant's position is that no deficit carry-over should be allowed, even if the 1936 transactions are to be treated as nontaxable.

"Even if these transactions are considered taxable it is plaintiffs' view that the deficit carry-over should be allowed and given effect beginning with the year 1943 in view of the legislative intent reflected in the remedial tax legislation which became effective for that year (The Revenue Act of 1943). Defendant contends that the legislative intent is inconsistent with that result.

"It is defendant's view that allowance of the deficit carry-over will permit a 'double deduction' for the same losses, and thus result in a windfall, while it is plaintiffs' view that no such windfall will be involved and in fact that the equities favor the deficit carry-over."

Plaintiffs have cited the provisions of the Revenue Act of 1939 throughout their briefs. The Government has cited the Revenue Act of 1936. We think the Revenue Act of 1936 is applicable because it became effective on June 22, 1936, (see Section 1003 of that Act). The citations to the different acts, however, are not of importance because the language of the particular clauses of Section 112 (G) (1) of both acts defines a "reorganization" as "a recapitalization," or "a mere change in identity, form, or place of organization, however effected." Plaintiffs do not contend that any of the other clauses are applicable. The same thing is true in regard to other sections of the Revenue Acts of 1936 and 1939 that are cited by the parties.

Plaintiffs argue that our controlling court's decision in United States v. Kavanagh, 8th Cir. 1962, 308 F.2d 824, was only "an approach * * * to the precise question pre-

sented by the instant case" (Plaintiffs' principal brief, page 75). The Government, on the other hand, argues that Kavanagh is controlling.

Plaintiffs contend that the result reached in Kavanagh is completely contrary to their interpretation of Commissioner v. Sansome, 2d Cir. 1932, 60 F.2d 931, Harter v. Helvering, 2d Cir. 1935, 79 F.2d 12, Commissioner v. Munter, 331 U.S. 210, 67 S.Ct. 1175, 91 L.Ed. 1441 (1947), Commissioner v. Phipps, 336 U.S. 410, 69 S.Ct. 616, 93 L.Ed. 771 (1949), and United States v. Snider, 1st Cir. 1955, 224 F.2d 165.

Plaintiffs rely most heavily upon El Pomar Investment Company v. United States, D.C.Colo., 1962, 210 F. Supp. 333, and its affirmance by the Court of Appeals of the Tenth Circuit, reported as United States v. El Pomar Investment Company, 10th Cir. 1964, 330 F.2d 872. Plaintiffs argue that those cases, when taken together with Snider, sustain their position.

The Government counters with the argument that the rationale of Snider was definitively limited by the Supreme Court's decision in Phipps, and that both decisions in El Pomar, if not distinguishable on the facts, are clearly wrong and should not be followed.

In brief, the Government contends that "the result in Kavanagh, not in El Pomar or Snider, is the proper one" and argues that the result of Kavanagh is consistent with the pertinent authorities, citing Helvering v. Southwest Corp., 315 U.S. 194, 62 S.Ct. 546, 86 L.Ed. 789 (1942); Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 62 S.Ct. 540, 86 L.Ed. 775 (1942); Palm Springs Holding Corp. v. Commissioner, 315 U.S. 185, 62 S.Ct. 544, 86 L.Ed. 785 (1942); Bondholders Committee Marlborough Inv. Co., First Mortgage Bonds v. Commissioner, 315 U.S. 189,

62 S.Ct. 537, 86 L.Ed. 784; and Helvering v. Cement Investors, Inc., 316 U.S. 527, 62 S.Ct. 1125, 86 L.Ed. 1649 (1942) as controlling.

Our study of the cases and what our controlling court had to say about them in Kavanagh convinces us that we must reach the same result in this case as the Court of Appeals reached in Kavanagh.

In one way or another, plaintiffs' arguments, in the final analysis, seek a judicial extension of what has became known as the Sansome rule in order to permit a carry-over of the deficit of a debtor corporation reorganized pursuant to Section 77B of the Bankruptcy Act to a new successor corporation organized pursuant to the approved plan of reorganization. We do not believe the so-called Sansome rule should be so extended.

In Sansome Judge Learned Hand did not deal with the deficit carry-over question here presented. He dealt with the different question of whether the surplus in the earnings and profits of an old corporation should carry-over to a successor corporation. The factual situation with which he dealt involved merely a new corporate charter that differed only from the old "only in that the company could manufacture other products besides silk, to which the charter of the old company had been confined." Judge Hand pointed out that "[t]here was no other change in the 'financial structure,' as the phrase is" (l. c. 932 of 60 F.2d).

A cursory reading of Sansome reveals that Judge Hand was once again engaged in demolition of the product of black letter reasoning as it related to the facts of corporate life. He pointed out that whether particular corporate transactions should or should not be said to "break the continuity of the corporate life, [was] a troublesome question that the courts had beclouded by recourse to

such vague alternatives as 'form' and 'substance', anodynes for the pains of reasoning" (l. c. 933 of 60 F.2d). It did not take him long to hold that merely because a "new and independent" corporation had been formed was not sufficient to support the Board's idea that the liquidating dividends of the new company had in fact been distributed out of its own capital and not out of the earnings and profits of the old corporation within the meaning of the applicable taxing statute.

The precise holding of Sansome was merely that "a corporate regoranization which results in no 'gain or loss' * * * does not toll the company's life as continued venture * * * and that what were 'earnings and profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings and profits' of the successor, or parent, in liquidation" (l. c. 933 of 60 F.2d).

That holding, of course, was not concerned with whether a deficit would or would not carry-over to the successor corporation. Indeed, it is difficult to comprehend how a deficit in earnings and profits could be, as a matter of logic, fitted into the language of Sansome for the realistic economic reason that a deficit in earnings and profits simply cannot be used for purposes of distribution. A deficit, of course, has a relationship to the question of when and how a distribution may be made, but only dividends, not deficits, may be declared.

Commissioner v. Munter, supra, involved another surplus case in which a quite mechanical application of Sansome had been made. The Supreme Court unanimously agreed that Sansome simply "held that implicit in the tax exemption of reorganization distributions was the understanding that the earnings and profits so exempt

were acquired by the new corporation and were taxable as income to stockholders when subsequently distributed" (l. c. 214-215 of 331 U.S., 1177 of 67 S.Ct.).

Commissioner v. Phipps, supra, involved the question of whether "the rule of Commissioner v. Sansome, 2 Cir., 60 F.2d 931, requires the subtraction of the subsidiaries' deficit from the parent's earnings and profits, in determining whether a subsequent distribution by the parent constitute[s] dividends or a return of capital to its stockholders" (l. c. 411 of 336 U.S., 617 of 69 S.Ct.). With express disapproval, the Supreme Court unanimously rejected cases that suggested that "[t]he rationale of the Sansome decision [rested on] * * * a 'continued venture' doctrine" (l. c. 416 of 336 U.S., 619 of 69 S.Ct.) Phipps held that "the Sansome rule is grounded not on a theory of continuity of the corporate enterprise but on the necessity to prevent escape of earnings and profits from taxation" (l. c. 417 of 336 U.S., 620 of 69 S.Ct.).

The taxpayer in Phipps argued that logic somehow required that the carry-over treatment given a surplus in earnings and profits should also be given a deficit in earnings and profits. The Supreme Court held that:

> "Respondent's contention that the logic of the Sansome rule requires subtracting the deficit of the subsidiary from the earnings and profits of the parent as a corollary of carrying over the earnings and profits of the subsidiary has a superficial plausibility; but the plausibility disappears when it is noted that the taxpayer would thus obtain an advantage taxwise that would not be available absent the liquidation since there is no way to 'declare' a deficit, and thus no method of loss realization open to the parent parallel to a declaration of dividends as a mode of realizing the profits of a subsidiary." (l.c. 420 of 336 U.S., 621 of 69 S.Ct.)

United States v. Snider, supra, upon which the district court in El Pomar and plaintiffs in this case so strongly rely, is based upon an acceptance of the "logic" that the Supreme Court in Phipps described to be of but "superficial plausibility"—a plausibility that "disappears when it is noted that * * * there is no way to 'declare' a deficit" (l.c. 420 of 336 U.S., 621 of 69 S.Ct.).

Without attempting to state what reasoning it had in mind, the First Circuit in Snider suggested that "it would appear to follow from the reasoning used in the Sansome case that the plaintiffs are entitled to recover, for logic would seem to require that if the prior business organization's profits and losses must be attributed to the successor corporation following a tax-free reorganization, similarly the prior enterprise's deficits should be attributed to the successor corporation" (l.c. 167 of 224 F.2d).

In spite of the fact Snider purported to recognize that Phipps had held that "subtracting the deficit * * * is not a corollary to the carrying over * * * earnings and profits" (l.c. 167 of 224 F.2d), it nevertheless proceeded to attempt to distinguish Phipps to the end of holding that "a logical application of the Sansome rule, even as that rule has been defined by the Supreme Court in the Phipps case, compels us to conclude that in determining whether distributions made to its stockholders by the [successor corporation] are dividends, the deficit of its * * * predecessor must be taken into account" (l. c. 168 of 224 F.2d).

While we believe Snider may well be distinguishable on the facts, we also believe that its sauce for surplus goose should be sauce for the deficit gander brand of logic is, in the language of Phipps, of but superficial plausibility.

We know of no logical reason why the existence of a judicial rule designed to prevent an escape of earnings and

profits from taxation by a successor corporation requires the establishment of another judicial rule that would prevent taxation of earnings and profits of a corporation that would have otherwise been taxable except for the fact that such corporation had happened to have acquired its assets from a predecessor who had been the debtor in a 77B corporate reorganization.

In contrast to our reaction, it is clear that the district court in El Pomar found that "the reasoning in the Snider case is persuasively logical and sound" (l. c. 336 of 210 F.Supp.). It is also clear, however, that the Court of Appeals of the Tenth Circuit in El Pomar did not share the district court's high regard for Snider. Judge Orie Phillips, in fact, noted that "commentators and text writers have placed a broader construction on the opinion in Phipps than did the First Circuit in Snider" (l. c. 882 of 330 F.2d).

For an example El Pomar quoted Wales' commentary at the Eighth Annual N.Y.U. Institute on Federal Taxation, pp, 920-924, as follows: The "rule that deficits do not survive the extinction of the corporation in which they arose * * * apparently has no exceptions" (l. c. 883 of 330 F.2d). The result of Snider, of course, was a direct violation of the rule that Wales believed to be without exception.

In like manner, Merten's Law of Federal Income Taxation, 1962 Ref. Vol. 1 § 9.52 p. 102, was quoted as follows: "[I]f the transferor or distributor had the deficit, that deficit would not wipe out earnings and profits of the acquiring corporation" (l. c. 883 of 330 F.2d). See also the authorities cited in footnote 11 on page 883 of 330 F.2d for other comment on Snider and Phipps to which Judge Phillips directed attention.

The Tenth Circuit in El Pomar held, consistent with what we have said, that "We think preventing tax avoidance

by means of tax-free reorganizations was the touchstone of Sansome and Phipps" (l. c. 883 of 330 F.2d). The judgment of the district court was affirmed, not on the theory upon which it had relied, but upon the theory that, on the facts, the result of the case was correct.

We need not examine the validity of the factual distinction made by the Tenth Circuit of Kavanagh in El Pomar. We must follow and apply Kavanagh to the stipulated facts in this case.

One might argue that Kavanagh rested solely upon its definitive determination that plaintiff failed to sustain "the burden of proving that the distributions in question were not made from current earnings or profits in the years of distribution and that there were no other accumulated earnings or profits from which such distribution could be attributed" (l. c. 832 of 308 F.2d).

But our duty requires that we follow more than the most narrow ground of decision of our controlling court. The orderly administration of justice requires us to read its decisions broadly and to apply its full teaching to later cases. We can not assume that our Court of Appeals writes merely for intellectual exercise. Kavanagh must therefore be read in light of how it accepted or rejected the rationale of the district court it reversed.

The district court's opinion in Kavanagh 187 F.Supp. 430, quoted at its outset the plaintiff's reliance upon Sansome and Snider. Generally speaking, it accepted the First Circuit's narrow interpretation of Phipps. Specifically, relying upon Snider, the district court held that "in determining whether the distributions made to its stockholders by the [successor corporation] are dividends, the deficit of its predecessor corporations must be taken into account" (l. c. 433 of 187 F.Supp.).

The Government's appeal, of course, set the stage for acceptance or rejection of the rationale of the district court's opinion. Before ruling on the burden of proof point, the Court of Appeals in Kavanagh determined that "neither the rule in Commissioner of Internal Revenue v. Sansome, 60 F.2d 931 (2 Cir. 1932) cert. den. Sansome v. Burnet, 287 U.S. 667, 53 S.Ct. 291, 77 L.Ed. 575, nor the reasoning of the Court in United States v. Snider, 224 F.2d 165 (1 Cir. 1955) relied on by the District Court are applicable to the stipulated facts and documentary evidence here" (l. c. 831 of 308 F.2d). A comparison to Humpage v. C. I. R., 17 T.C. 1625, was then directed.

The Court of Appeals in Kavanagh evidenced its acceptance of the rationale of Phipps and of Humpage when it stated that:

> "No 'deficit carryover' could possibly have followed from the old to the new reorganized company from the standpoint of accounting, nor legally, as a consequence of the 77B proceedings.
>
> "The only inference to be made from the stipulated facts and documentary evidence in the case at bar is that Bell-Sorensen started out with a new financial slate." (l. c. 831 of 308 F.2d).

It would seem to be clear that the Court of Appeal's opinion in Kavanagh accepts fully the implication of Phipps that neither "logic" nor Sansome requires that an earnings and profits deficit be carried over in the same manner as an earnings and profit surplus.

Plaintiffs concede that "the old common stock [of the debtor corporation] as such was obviously wiped out" (plaintiffs' principal brief, page 56). If continuity is either a factual or a legal consideration, we find that such continuity, as it was defined in the earlier cases, can not be said to exist under the stipulated facts of this case.

The earlier continuity cases to which we make reference are best illustrated by the four decided by the Supreme Court on February 2, 1942. Those cases, Limestone Co., Palm Springs Corp., Bondholders Committee, and Southwest Corp., reflect the quite fundamental change in regard to "reorganizations" introduced in federal tax law by the Revenue Act of 1934.

Limestone, for example, applied § 112 (i) (1) of the Revenue Act of 1928. That statute provided that "[t]he term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation * * *". Applying that statute, Limestone held that "Insolvency reorganizations are within the family of financial readjustments embraced in [the words "merger" and "consolidation" as] those terms as used in this particular statute" (l. c. 184 of 315 U.S., 544 of 62 S.Ct.). Palm Springs and Bondholders represent factual variations of applications of that same broad statutory language.

Southwest Corp., however, involved the new Section 112(g) (1) of the Revenue Act of 1934 which first introduced the same statutory language involved in this case. That case pointed out that "[u]nder the statute involved in Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 62 S.Ct. 540, 86 L.Ed. 775, * * there would have been a 'reorganization' here" (l. c. 198 of 315 U.S., 550 of 62 S.Ct.). That case further held that clause (B) and the other clauses of the new statute (Section 112(g) (1) of the Revenue Act of 1934) had made important changes in the law defining a "reorganization" and that cases construing the definitions contained in earlier statutes were not applicable to the more narrow statutory definitions provided in the new law.

Of specific impact on the case at bar was the construction placed by Southwest Corp. on clause (D), defin-

ing a "reorganization" as "a recapitalization," and on clause (E), defining a "reorganization" as "a mere change in identity, form, or place of organization, however effected."

Southwest Corp. held that clause (D) was not applicable to a transaction in which an equity court approved a plan of reorganization that included the organization of a new corporation that would acquire the assets of the old, and in which the rights of the security holders of the old corporation would be drastically altered. Under the plan of reorganization there involved, the common stockholders of the old corporation would be wiped out except for stock purchase warrants and the common stock of the new corporation would be issued to former bondholders and unsecured creditors of the old company. The Supreme Court held that such a transaction "was not that reshuffling of a capital structure, within the framework of an existing corporation, contemplated by the term 'recapitalization'" (l. c. 202 of 315 U.S., 552 of 62 S.Ct.).

The definition set forth in clause (E) was likewise held by Southwest Corp. to be inapplicable because "a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization' within the meaning of clause (E)" (l. c. 202-203 of 315 U.S., 552 of 62 S.Ct.).

Plaintiffs suggest, however, that if a corporation "without altering its capital structure," merely changes its state of incorporation, the transaction would clearly fall within the definition of a clause (E) reorganization (we use the clause letters of the Revenue Act of 1936, rather than plaintiffs' citation of Clause (F) of the 1939 Code). Plaintiffs then suggest that if "no change in corporate domiciles had been involved" in the reorganization and that if the changes

in capital structure could be considered a "recapitalization" under the cases, then there would have been a "reorganization" within the definition of clause (D) of Section 112(g)(1).

Plaintiffs then argue that "if the recapitalization and the change of corporate domicile had taken place at different times, and in separate and unrelated transactions, the two statutory provisions would have been applicable in the sequence in which the transaction occurred" (page 29 of plaintiffs' principal brief).

Plaintiffs seek separate, in point of time, applications of clauses (D) and (E). They seek to separate particular details of the mechanical procedure taken in the consummation of the full transaction because they concede that it would be impossible to contend that "the [debtor] company's reorganization considered as a unitary transaction was a 'mere change' of form, identity, or domicile" (page 41 of plaintiffs' principal brief).

Plaintiffs therefore argue that the execution of the 77B reorganization plan and the 77B proceeding itself should not be considered as a unitary transaction. Plaintiffs would have us determine that "what actually occurred in the instant case can be closely equated to a change of domicile followed within a short time by a recapitalization" (pages 29-30 of plaintiffs' principal brief).

We do not believe that plaintiffs' argument can be sustained because the broad thrust of the Supreme Court's teaching in the reorganization cases just discussed is to the effect that "[t]he legal procedure employed by the creditors is not material" (Palm Springs Holding Corp., l.c. 188 of 315 U.S., 546 of 62 S.Ct.), and to the effect that "the precise mechanics whereby the reorganization was consummated are not material" (Bondholders Committee, l.c.

191 of 315 U.S., 539 of 62 S.Ct.). Compare also the rationale of Limestone where arguments as to what had taken place "technically" were rejected in favor of a judicial view that "conforms to realities" (l.c. 183 and 184 of 315 U.S., 62 S.Ct. 540).

Plaintiffs' argument simply does not conform to the legal and factual realities that exist in 77B reorganization proceedings in general and those that were stipulated to have existed in the particular 77B reorganization proceeding involved in this case. The old debtor corporation found itself in a position where it was insolvent in the sense of being unable to meet its obligations as they matured.

The organization of a new Delaware corporation was not, in fact, a "mere change of form, identity, or place of organization" of the debtor corporation; the utilization of that legal step was an integral and necessary part of the overall legal procedure that would eventually establish, outside the framework of the existing debtor corporation, new rights and interests of persons who had been stockholders and creditors of the debtor corporation, a corporation that, under the judicially approved plan, was destined for extinction.

The factual realities require recognition of the fact that the entire 77B proceeding was designed, as Kavanagh quite tersely suggests, to start a new corporation out "with a new financial slate." The earned surplus account on the balance sheet of the new corporation, as of December 1, 1936, per the company books was recorded as zero. So far as book entries were concerned in 1936, it is clear that no one thought in 1936 that any deficit carry-over was supposed to have "followed from the old [debtor corporation] to the new reorganized company from the standpoint of account-

ing, nor legally, as a consequence of the 77B proceeding," to again borrow the language of Kavanagh (l. c. 831 of 308 F.2d). For a similar pragmatic approach to a different tax problem involving a 77B proceeding as that taken by Kavanagh, see Willingham v. United States, 5th Cir. 1961, 289 F.2d 283, 286-287).

And, all questions of estoppel to one side, the stipulated facts further establish that in correspondence between the new corporation and the Deputy Commissioner of Internal Revenue in 1937 and 1938, the new corporation was advised that the 77B reorganization was not a reorganization within the meaning of Section 112(g) (1). That ruling was accepted for many tax purposes, not important to discuss here, but we think it important to point out that the tax returns of the new corporation were filed on the premise that the 77B reorganization was not a tax-free reorganization.

We believe the facts stated are important as data which recognized and therefore supports our appraisal of the realities of the 77B reorganization. We, of course, find that plaintiffs' argument that the letter ruling was erroneous is not tenable for all the reasons we state in this memorandum opinion.

We turn now to plaintiffs' contention that even if it is determined that its position in regard to Section 112(g) (1) is not sustained, we must nevertheless determine that under Section 112(b) (5) the debtor corporation's 77B reorganization was not a taxable transaction. Helvering v. Cement Investors, 316 U.S. 527, 62 S.Ct. 1125, 86 L.Ed. 1649 (1942) is relied upon.

That case, of course, does hold that "the fact that [a particular transaction] cannot meet the statutory standards of a 'reorganization' [as defined in the various clauses of

Section 112(g) (1)] does not necessarily mean that it cannot qualify as an 'exchange' [as defined in Section 112(b) (5)], any more than the failure to satisfy one clause of the 'reorganization' provisions [of Section 112(g) (1)] means that none can be satisfied" (l.c. 534 of 316 U.S., 1128 of 62 S.Ct.).

But that case does not hold that because a particular transaction may factually qualify as an "exchange" within the meaning of Section 112(b) (5) that it necessarily follows that all transactions approved pursuant to 77B plan of reorganization must be said to qualify as an "exchange" under Section 112(b) (5). Each case must turn on its own facts.

The controlling facts in Cement Investors required an application of the doctrine of Limestone by virtue of which the Supreme Court, in order to conform to realities, considered that the ownership of the entire equity interest in the old corporation had passed to its creditors at least by the time the 77B proceedings were instituted.

The "exchange" under consideration in Cement Investors, was therefore, by operation of law, considered to be an exchange made by the creditors of the old corporation of their then presently existing equitable claim in or to the property that had been owned by the debtor corporation.

Under the facts there involved, the interests of the old stockholders had been excluded by operation of law long before any plan of reorganization had been submitted or approved by the reorganization court. Under the facts stipulated in this case, plaintiffs concede that the debtor corporation's financial condition was such that "the bondholders and other creditors were * * * not entitled to completely exclude the prior equity interests" (page 56 of plaintiffs' principal brief).

It is therefore apparent that the factual situation stipulated here and that presented in Cement Investors is quite different. We therefore cannot say in this case, as the court was required to say in Cement Investors, that "property" was transferred in "exchange for stock or securities" and that those who exchanged the "property" were thereafter "in control of the corporation," as required by Section 112(b) (5).

Our analysis of the stipulated facts also requires the additional finding and conclusion that any realistic appraisal of any exchange that could be said to have been made does not establish the requisite 80 per centum of the total voting power in any transferor of property within the definition of Section 112(b) (5). For all the reasons stated we hold that Section 112(b) (5) is not applicable.

Plaintiffs also contend that the Section 112(b) (10), enacted in 1943, is applicable. Plaintiffs concede, however, that the 1943 Amendment was intended to operate retroactively only in the sense that it could be applied to any bankruptcy reorganization that occurred after December 31, 1933, and that the new provisions "were intended as prospective beginning with the year 1943 in the sense that the tax treatment of a reorganization which had in fact been adopted by the corporation and its security-holders during prior years was to be left undisturbed as to those years" (page 50 of plaintiffs' principal brief).

The reorganization here involved was, of course, treated as a taxable transaction. The short, but we believe complete, answer to plaintiffs' Section 112(b) (10) argument is that the Congress indicated no intention to act retroactively to the end that a 1936 taxable transaction should be converted into and considered at a later date as a tax-free reorganization for deficit earnings and profits purposes. We so hold.

Plaintiffs contend finally that "the equities favor the deficit carry-over" (page 2 of plaintiffs' reply brief). The Government, of course, argues to the contrary. We note in passing that Kratz, in his article "Loss Carryovers in Chapter X Reorganizations," 16 Tax Law Review 359, 407, suggests that "it may be questioned whether * * * the debtor's deficit in earnings and profits * * * be carried over to the acquiring corporation * * * is a desirable result."

His comment on page 409, however, that "relief must come from Congress" defines the permissible scope of our inquiry into the matter of equities. We must presume that the Congress weighed the equities when it wrote the statutes before us.

It is our limited function and duty to construe and apply the statutes before us in light of the rules of decision of our controlling courts. In the discharge of that duty and for the reasons stated, we conclude the issues in favor of the defendant.

The Government shall, within fifteen (15) days, present a form of final judgment consistent with the stipulation of the parties and this memorandum opinion. The proposed form of final judgment shall be submitted to counsel for the plaintiffs for approval as to form.

It is so ordered.

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 17,952

Richard H. Dunning and Beulah Marie Dunning,
Appellants,
v.
United States of America,
Appellee.

Appeal from the United States District Court for the Western District of Missouri.

[December 22, 1965.]

Before VAN OOSTERHOUT and MEHAFFY, Circuit Judges, and MEREDITH, District Judge.

VAN OOSTERHOUT, Circuit Judge.

This is a timely appeal by taxpayers, Richard H. Dunning and Beulah Marie Dunning, from final judgment of the District Court dismissing their suit to recover alleged overpayments of income tax for the years 1958, 1959 and 1960, in the respective amounts of $27.83, $26.15 and $29.78. Taxpayers owned stock during each of such years in the Missouri Public Service Company and received cash distributions in the amount of $511.20, $548.46 and $827.28 respectively. Such stock distributions were reported in taxpayers' federal income tax returns as dividend income and tax was paid thereon. Thereafter, taxpayers filed timely claims for refund based upon the ground that the predecessor of the present Missouri Public Service Company had a deficit in accumulated earnings which passed to the present corporation, and that

such deficit offset the accumulated earnings of the present corporation and thus the portion of the distribution for each year which exceeded current earnings and profits was a return of capital and not taxable as dividend income. Taxpayers concede that the portion of the distributions paid out of current earnings is taxable as dividend income under § 301 I.R.C. 1954.

Jurisdiction exists in the trial court under 28 U.S.C.A. § 1346(a) (1).

Judge Oliver, in his memorandum opinion reported at 232 F.Supp. 915, fairly summarizes the facts, all of which are stipulated, sets out in detail the issues and contentions of the parties, cites and discusses relevant cases and upon the basis thereof denies taxpayers the relief which they sought.

The controlling issue presented by this appeal is whether the District Court correctly decided under the facts and circumstances disclosed by the record that the present corporation, Missouri Public Service Company, is not entitled to offset against its own accumulated earnings and profits the pre-1936 earnings and profits deficit of its predecessor corporation which had been discharged in a 77B bankruptcy proceeding. The present corporation has had sufficient accumulated earnings subsequent to the 77B reorganization to cover the entire distributions made in 1958, 1959 and 1960.

The parties have stipulated that "if no part of the deficit of the debtor Missouri Public Service Company as of November 30, 1936, is carried over beyond that date and the earnings and profits as of December 1, 1936, are to be considered zero, then all the distributions through the years, including the three years involved in this action, constitute taxable dividends." 232 F.Supp. 915, 919.

Taxpayers contend that the reorganization arising out of the bankruptcy proceedings is a non-taxable reorganization under § 112(g) (1) (E) and (F) I.R.C. 1939 (formerly Revenue Act of 1936 § 116(g) (1) D and E), or if it was not a tax-free reorganization, the exchange which occurred was a non-taxable exchange under § 112(b) (5) I.R.C. 1939. While the Government vigorously disagrees with the foregoing contentions, it states in its brief that even if it be assumed that the 1936 exchange was non-taxable under any of the theories advanced by taxpayers, the taxpayers cannot prevail because the pre-reorganization deficit of the bankrupt corporation was under the facts of this case completely extinguished by the bankruptcy proceedings, leaving no accumulated deficit to carry over.

Section 316 I.R.C. 1954 provides:

"SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. . . ."

As heretofore stated, taxpayers concede that the distributions made are taxable as dividends to the extent of current earnings. In order to escape dividend treatment as to the balance of the distributions, the burden is upon the taxpayers to show that the corporation had no accumulated earnings or profits from which the distribution could be made. *United States* v. *Kavanagh,* 8 Cir., 308 F. 2d 824, 832; *McCullough* v. *United States,* Ct. Cl., 344 F. 2d 383, 385. Taxpayers have failed to meet such burden.

It is conceded that the present corporation had accumulated sufficient earnings and profits subsequent to the 1936 reorganization to fully cover the distributions made unless it is entitled to claim the pre-reorganization loss of its predecessor. Such predecessor, bearing the same name and herein referred to as the bankrupt, was incorporated in Missouri in 1926. In 1935 such corporation, being unable to meet its financial obligations as they matured, filed for reorganization under 77B (now Chapter 10) of the Bankruptcy Act in the Northern District of Illinois. A plan of reorganization was thereafter submitted and approved by the interested parties and by the court. The effective date of such reorganization was November 30, 1936. Pursuant to such reorganization plan, all of the assets of the bankrupt were turned over to the newly organized company, the Missouri Public Service Company of Delaware. Such company had entered an appearance in the reorganization proceedings and had agreed to the terms of the reorganization plan. Under the terms of the reorganization plan, which are more fully set out in the trial court's opinion, the pre-existing 59,970 shares of common stock of the debtor, which carried a book value of $2,999,500, were in effect completely wiped out. Immediately prior to the reorganization all of such common stock was beneficially owned by Middle West

Utilities Company. It received no stock or other consideration for its common stock in the bankrupt corporation except it was issued warrants expiring December 31, 1939, authorizing it to purchase 13,000 shares of stock in the new corporation at $25 per share. Such rights were never exercised. The record discloses that the highest market price attained by the new stock was $6.25 a share and that no offer could be obtained for the warrants.

The holders of the preferred stock, which had a book value of nearly $100 a share, received one and one-half shares of new common stock for each share of preferred stock. Holders of $6,351,000 of the bankrupt's bonds due in 1947 received $4,445,700 in new bonds due in 1960, or 70% of the original bond indebtedness. They also received $52.50 interest on each $1,000 bond and one share of common stock for each $100 in bonds. The holders of notes and accounts payable were paid in common stock. One hundred thirty three thousand, seven hundred and five shares of new stock were issued, of which the preferred shareholders received 22.39%, the bondholders 47.5% and the creditors 30.11%. Middle West was the principal creditor of the bankrupt, holding notes and accounts payable aggregating $1,348,314, for which it received 40,136 shares of stock in the new corporation.

The balance sheet of the bankrupt immediately prior to reorganization shows total book value of assets of $14,164,551 and liabilities in the same amount. The December 1, 1936, post-reorganization statement shows reduction of assets and liabilities to $9,426,610.35. Extensive appraisals were made of the bankrupt's assets by appraisers and by the Missouri Public Service Commission and the reductions were brought about in order to reduce the book valuation of the assets to something approaching its actual value.

It is stipulated that the pre-reorganization deficit in earnings and profits of the bankrupt is $1,465,628. Taxpayers in brief claim this figure should be some $400,000 higher by reason of other items properly chargeable to earnings and profits. It would appear that the accumulated deficit was at least an important factor in bringing about the debtor's filing of the 77B petition. Liabilities of the debtor in excess of the accumulated deficit in earnings were wiped out in the bankruptcy proceedings.

The trial court quotes from our opinion in *Kavanagh* as follows:

> " 'No "deficit carryover" could possibly have followed from the old to the new reorganized company from the standpoint of accounting, nor legally, as a consequence of the 77B proceedings.
>
> " 'The only inference to be made from the stipulated facts and documentary evidence in the case at bar is that Bell-Sorensen started out with a new financial slate.' (l. c. 831 of 308 F.2d)."

and then goes on to say:

> "It would seem to be clear that the Court of Appeals' opinion in *Kavanagh* accepts fully the implication of Phipps that neither 'logic' nor Sansome requires that an earnings and profits deficit be carried over in the same manner as an earnings and profits surplus."
>
> . . . . . .
>
> "The factual realities require recognition of the fact that the entire 77B proceeding was designed, as *Kavanagh* quite tersely suggests, to start a new corporation out 'with a new financial slate.' The earned surplus account on the balance sheet of the new corporation, as of December 1, 1936, per the company books was recorded as zero. So far as book entries were concerned in 1936, it is clear that no one thought

> in 1936 that any deficit carry-over was supposed to have 'followed from the old [debtor corporation] to the newly reorganized company from the standpoint of accounting, nor legally, as a consequence of the 77B proceeding,' to again borrow the language of *Kavanagh* (l. c. 831 of 308 F.2d) . . . 323 F.Supp. 915, 923, 925.

Taxpayers urge that in this case, as well as in *Kavanagh,* it was error to place any significance upon the fact that no balance sheet or any other financial statement appeared in the record which revealed any carry-over of the pre-existing earnings deficit. We did not hold in *Kavanagh* nor do we hold here that such factor standing alone is controlling under all circumstances. For some purposes, it may be entirely true that general financial statements do not always reflect all information pertinent to tax liability. However, the entries on the corporate records are entitled to consideration. See *McCullough* v. *United States,* supra (p. 391 of 344 F.2d and footnote 21). Taxpayers urge that *Kavanagh* is factually distinguishable from the instant case and that by reason of such distinctions, it is not controlling here. There are of course factual distinctions but we believe that the principles announced and followed in *Kavanagh,* hereinabove set out, apply here.

Taxpayers place considerable reliance on the doctrine of *Commissioner* v. *Sansome,* 2 Cir., 60 F.2d 931, and *United States* v. *Snider,* 1 Cir., 224 F.2d 165, and *United States* v. *El Pomar Investment Co.,* 10 Cir., 330 F.2d 872. *Sansome* and *Snider* were fully considered by us in *Kavanagh,* and all of the cases relied upon are carefully analyzed and considered by the trial court in its well-written opinion. As pointed out by the trial court, *Commissioner* v. *Phipps,* 336 U.S. 410, 417, holds that the *Sansome* rule is designed to effectuate the Congressional purposes to tax

all stockholders who receive distributions of corporate earnings and that such purpose cannot be frustrated by any reorganization which leaves earnings or profits undistributed in whole or in part. The Supreme Court in *Phipps* states, "We conclude from the cases that the *Sansome* rule is grounded not on a theory of continuity of the corporate enterprise but on the necessity to prevent escape of earnings and profits from taxation." 336 U.S. 410, 417.

We adhere to our view expressed in *Kavanagh* that the *Sansome* rule does not apply to loss of earnings carry-over such as the one involved in the instant case. *El Pomar* relied upon by taxpayers contains an excellent discussion of the reasons why the *Sansome* rule should not apply to loss carry-overs. The Court of Appeals in *El Pomar,* pp. 882-83 of 330 F.2d, sets forth criticisms which followed such an application in the *Snider* case, then reverses its district court and properly holds that preventing tax avoidance by means of a tax-free reorganization is the touchstone of *Sansome* and *Phipps* and determines that the reorganizations it was considering were not carried out to avoid taxes, and hence, "The basis for the rule laid down in *Sansome* and *Phipps* being absent in the instant case, we think the rule should not apply." 330 F.2d 872, 884.

The *El Pomar* court distinguishes our *Kavanagh* case, pointing out that the reorganization before it was carried out voluntarily, whereas the *Kavanagh* reorganization took place in a 77B proceeding. It also emphasizes that in *Kavanagh* all claims, both secured and unsecured, were adjusted while in the second reorganization in *El Pomar* "only secured indebtedness of the bondholders was adjusted. Such adjustments increased the shareholders' equity. The indebtedness of all the other creditors . . . was paid in full." 330 F.2d 872, 884. Thus, the issue of whether

any deficit in earnings will remain as a result of a reorganization ordinarily presents a fact issue to be determined upon the facts of the particular case.

In addition to *Kavanagh*, the Government relies upon three recent decisions to support its position: *McCullough* v. *United States*, Ct.Cl., 344 F.2d 383, cert. denied Nov. 8, 1965; *Banister* v. *United States*, E.D.Mo., 236 F.Supp. 972, appeal to Eighth Circuit dismissed May 12, 1965; *Caspers* v. *Commissioner*, 44 T.C. 411; cf. *Willingham* v. *United States*, 5 Cir., 289 F.2d 283. *McCullough*, *Caspers* and *Banister* all deal with the same 77B reorganization, that of the Frisco Railway Co. in 1947. Frisco had been placed under trusteeship for the benefit of creditors in 1933 under the provisions of § 77B. The trusteeship continued for fourteen years showing "aggregate losses during the entire period of the reorganization . . . of $50,958,028.90." 236 F.Supp. 972, 973. When the plan of reorganization was finally approved and the successor corporation began operations on its own, the pre-reorganization deficit was claimed against cash distributions to the stockholders of the new company. The courts in all three cases refused to allow the offset. The first decision, *Banister*, was followed in *McCullough* and *Caspers*. In its findings to the effect that the disposition of Frisco's liabilities in bankruptcy was to deny any later offsets against cash distributions by the successor corporation, the *Banister* court found that:

> "To allow plaintiffs' contentions to prevail in this case would be to give Frisco a position of 'having its cake and eating it too.' It would be allowing Frisco to proceed through bankruptcy and reorganization and thereby obtain a complete discharge of its liabilities but yet being able to continue its operations. Then, despite the discharge of the old debts in the reorganization, plaintiffs would have Frisco now use the pre-reorganization deficit created by those liabil-

> ities to offset its earnings and profits of subsequent business years. It is a double benefit that is sought: Escape of liability for its debts, but also escape from taxation of its shareholders by taking advantage of its former operating deficit. It was not the purpose of either the bankruptcy or the tax laws to permit such a doubled advantage. As of the 1947 reorganization of Frisco it received a clean slate; it was able to continue operations as a going concern, free of its former economic burdens. But, along with this fresh start went the duties and burdens shared by all businesses, one of these being taxation of its own income and the dividend income of its shareholders, and the distribution of dividends by a corporation to its shareholders does not lose its true nature by the distributing corporation merely calling it one out of capital.
>
> There was no existing deficit which Frisco could take advantage of and thereby make its distribution one out of capital. Therefore, the only result is that it was a dividend paid out of earnings and profits to shareholders and fully taxable to them as dividend income." 236 F.Supp. 972, 974-75.

The *Banister* language quoted above was based in large measure on the court's reading and interpretation of our *Kavanagh* opinion.

While as heretofore stated we do not believe the question of whether or not the reorganization is tax free is material to our decision, we note that in *McCullough* the Commissioner conceded and the court found that the reorganization was tax free. Nevertheless, the court held the deficit would not carry over to the reorganized corporation. The court states:

> "[W]e find little value in speculating as to what might have happened tax-wise if the Frisco had not undergone reorganization. The fact of the matter is that the state of the Frisco's business and its financial

condition were such that reorganization under section 77 of the Bankruptcy Act was required and was accomplished. The crucial considerations regarding the question of deficit survival are, in the opinion of this court, the nature of the reorganization and the consequent alteration of the railroad's financial situation." 344 F.2d 383, 389.

The *McCullough* court places considerable significance upon the fact that the interests of pre-existing stockholders were wiped out, and that the reorganization worked substantial change in Frisco's position with its former creditors, secured and unsecured, and that it had liabilities of $269,119,202 and owed accrued interest in the amount of $101,442,552 but emerged from the reorganization with a capitalization of $251,628,494. The court observes,

> "In view of these facts, we consider the position of the plaintiffs that the (receivership and) reorganization had no effect upon the Frisco's earnings and profits account to be untenable. . . . Under these circumstances, we are not willing, in determining the question of deficit carry-over, to disregard the effects of the reorganization. We are inclined to agree with the court in *Banister*, supra, that, under plaintiffs' view, the Frisco would be in a position of 'having its cake and eating it too.'
>
> "Furthermore, as indicated in our discussion of *Banister* v. *United States*, supra, this court accepts defendant's assertion that the recapitalization of the Frisco eliminated the deficit in earnings and profits." 344 F.2d 383, 390.

The court qualifies its holding by stating, "In making this determination, we do not attempt to state a general rule regarding the effect of 'reorganizations' or recapitalizations upon deficits in earnings. Rather, our holding is limited to the circumstances of the Frisco reorganization." 344 F.2d 383, 390.

In our present case, the wiping out of the old capital stock, the downward adjustment of the preferred stock, the substantial adjustment of both secured and unsecured indebtedness, and the decrease in capitalization are comparable with the factors which the *McCullough* court found to be significant in determining that no deficit in earnings remained after the reorganization.

The taxpayers have failed to meet the burden imposed upon them to show that any loss of earnings account remained after the reorganization which could be carried over. Upon this record, the trial court was fully warranted in determining that the deficit in earnings account of the bankrupt corporation was completely wiped out by the bankruptcy proceedings and that consequently no deficit in earnings account remained for transfer to the successor.

It is stipulated that if the present corporation is not entitled to the benefit of the deficit in earnings of its predecessor that its accumulated earnings are sufficient to cover all the disbursements made in the taxable years involved. The court rightly determined under the facts and circumstances of this case that the disbursements were made out of earnings and hence were taxable.

We recognize that corporate reorganizations, whether they result from voluntary arrangements or under Chapter 10 of bankruptcy proceedings, are not all alike, and that such reorganizations may vary greatly with respect to the amount of economic distress involved and as to reorganization plans that may be adopted. Hence, like the Court of Claims in *McCullough,* we decide this case upon the facts before us and we are not laying down any absolute rule regarding the effect of bankruptcy reorganizations upon earnings deficits under all conceivable situations.

Determination that no earnings deficit remained after the bankruptcy reorganization which could be carried over to the successor corporation is dispositive of this appeal. Therefore, we do not reach or discuss other issues raised by the parties.

The judgment appealed from is affirmed.

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 17,952. September Term, 1965.

Richard H. Dunning and Beulah Marie Dunning, Appellants, v. United States of America.	Appeal from the United States District Court for the Western District of Missouri.

This cause came on to be heard on the record from the United States District Court for the Western District of Missouri, and was argued by counsel.

On Consideration Whereof, It is now Here Ordered and Adjudged by this Court that the Judgment of the said District Court, in this cause, be, and the same is hereby, affirmed.

December 22, 1965.

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 1138

RICHARD H. DUNNING AND BEULAH MARIE DUNNING,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioners, shareholders of the Missouri Public Service Company (New Missouri), claim that a portion of the cash distributions they received from that corporation in 1958, 1959, and 1960 exceeded current and accumulated earnings and profits and to that extent constituted a return of capital. Resolution of this question depends on whether New Missouri, which was reorganized in a proceeding under Section 77B of the Bankruptcy Act[1] on December 1, 1936, is

[1] Bankruptcy Act, c. 541, 30 Stat. 544, Section 77B, as added by the Act of June 7, 1934, c. 424, 48 Stat. 911, Section 1.

219-060—66

entitled to carry over the pre-reorganization deficit of its predecessor (Old Missouri) to offset its own post-reorganization earnings and profits (Pet. App. 27–28). All parties agree that unless the deficit is carried over, New Missouri had sufficient accumulated earnings to make each of the 1958–60 distributions fully taxable as a dividend (Pet. App. 30).

In the 1936 reorganization, it was determined that the value of Old Missouri's assets was not sufficient to entitle the common stockholders to any direct interest in the reorganized company, and thus under the plan of reorganization the bondholders and preferred stockholders received all the common stock of New Missouri.[2] Since Old Missouri's sole common stockholder (Middle West Public Utilities Corporation) held a substantial amount of that corporation's bonds, it received, qua bondholder, approximately 30 percent of New Missouri's common stock. Old Missouri's preferred stockholders received approximately 22 percent of New Missouri's capital stock. Thus, Old Missouri's former equity holders owned approximately 52 percent of New Missouri's capital stock (Pet. 5; Pet. App. 30–31).

[2] Technically, the common stock was exchanged for warrants entitling the holder to purchase an aggregate of 13,000 shares of New Missouri's common stock. However the warrants had no fair market value when issued or at any time thereafter and none was ever exercised. In their opening brief in the court of appeals, petitioners admitted that the common stockholder was (Br. 55) "wiped out" and the court of appeals agreed that the issuance of the warrants did not reflect any residual equity on the part of the common stockholder and was not of substantive significance in disposing of the issues presented (Pet. App. 30–31).

On these facts both of the lower courts held that Old Missouri's pre-reorganization deficit did not survive the reorganization and could not be used to offset New Missouri's post-reorganization accumulated earnings.

The decision below is correct, and the allegedly contrary decision of the Court of Appeals for the Tenth Circuit in *United States* v. *El Pomar,* 330 F. 2d 872, is distinguishable on its facts.

1. Any distribution made by a corporation to its shareholders out of either current earnings and profits or earnings and profits accumulated since 1913 constitutes a dividend. Int. Rev. Code of 1954, § 316. Distributions in excess of earnings and profits constitute a return of capital. § 301(c). Congress selected accumulated earnings to serve as the yardstick in order to distinguish distributions that represent a return *of* original invested capital from those corporate distributions that represent a return *on* original invested capital (*i.e.,* a dividend). Thus, the existence of an earnings deficit indicates that corporate losses have impaired the original contributed capital to the extent of the deficit and any distributions to stockholders would constitute a further impairment, *i.e.,* a return of capital.

When, as in this case, it has been determined in a bankruptcy proceeding that operating losses (which are reflected in the deficit) plus declines in the market value of the corporate assets (which are not taken into account in computing earnings and profits) have completely extinguished the common stockholder's in-

vestment, elimination of the stockholder from participation in the reorganized corporation, qua stockholder, should also eliminate the deficit. After the bankruptcy reorganization, the common stockholder was entitled to recognize its loss on its common stock investment (through a worthless stock deduction—see 1954 Code, § 165(g)). Since the corporate losses which created the deficit and (along with the market value decline) caused the elimination of the common stockholder's interest were recognized by the eliminated stockholder at the time of the original insolvency proceedings, the deficit should also be closed out. See *McCullough* v. *United States,* 344 F. 2d 383 (Ct. Cl.), certiorari denied, 382 U.S. 901. In other words, since the effect of the 1936 reorganization was to wipe out the capital contribution of the old common stockholders and to substitute therefor the capital contributed by the new common stockholders through the conversion of their debt and preferred stock into common stock, dividends paid on the latter out of earnings since 1936 do not constitute a return of capital.

It would make no sense to permit the deficit to be carried over to New Missouri. The amount of Old Missouri's deficit bore no relation to the new stockholders' (former bondholders and preferred stockholders) investment in Old Missouri. For example, assume that Old Missouri's original common stockholder invested $1,000,000 and that bondholders and preferred stockholders invested an additional $500,000, that the corporation lost $1,000,000 and then went

through a bankruptcy reorganization with the bondholders and preferred stockholders receiving all the new corporation's common stock. The deficit of $1,000,000 would have no relationship to the capital invested by the new stockholders ($500,000), or to their unrecognized gain or loss on the exchange of their bonds and preferred stock for common stock. However, if the deficit were carried over, the new corporation could earn $1,000,000 and in a later year distribute that amount as a "return of capital" to a group whose total investment was only $500,000 and whose entire investment is still intact.

The incongruity of carrying over the deficit is not diminished where, as here, the sole common stockholder of the old corporation also owned some of the new corporation's outstanding bonds and received a stock interest in the new corporation in exchange for its bonds. Elimination of its interest in the Corporation qua stockholder would still give rise to a $1,000,000 worthless stock deduction.[3]

Thus, both courts below correctly held that the bankruptcy reorganization eliminated Old Missouri's deficit and that there was thus no deficit to carry forward to New Missouri. Any other conclusion would have resulted in a competely unjustified tax

[3] Assuming *arguendo*, as did the court of appeals below (Pet. App. A 29), that the bankruptcy reorganization constituted a tax-free corporate reorganization under § 112 of the Revenue Act of 1936, c. 690, 49 Stat. 1678, the common stockholder's receipt of warrants would not constitute stock or securities subject to § 112's non-recognition provisions and the common stockholder was required to recognize its loss in 1936. See *Helvering* v. *Southwest Corporation*, 315 U.S. 194.

benefit akin to a double deduction (once to the old stockholder as a worthless stock deduction and again for the benefit of the new stockholders in eliminating the new corporation's taxable earnings).[4]

2. Petitioners allege that there is an "irreconcilable conflict" (Pet. 9) between the instant decision and the decisions in *United States* v. *Snider*, 224 F. 2d 165 (C.A. 1), and *United States* v. *El Pomar Investment Co.*, 330 F. 2d 872 (C.A. 10). *Snider* is completely distinguishable from the instant case. It involved a Massachusetts real estate trust (taxable as a corporation) operating two unsuccessful hotels which was reorganized into a parent and subsidiary corporation. No bankruptcy proceeding was involved and there was no material change in shareholders, assets, liabilities or business operations. Accordingly, the court held that the deficit of the trust carried over to the parent corporation.

El Pomar involved a bondholder's purchase of the assets of an unsuccessful corporation at a foreclosure sale in 1920. The assets were transferred to a new corporation in which the bondholders received new bonds and common stock. In 1930, a second foreclosure sale occurred and the assets were transferred to a third corporation. As a result of the first reorganization, all

[4] This result is also in accord with standard accounting practice. See, *e.g.*, Paton and Dixon, *Essentials of Accounting* (1958 ed.), pp. 645–649. Accordingly, no entry was made on the books of the reorganized company to reflect the claimed deficit (Pet. App. 32–33).

of the shareholders of the second corporation also owned bonds of that corporation and consequently, as in the instant case, the shareholders of the second corporation received (qua bondholders) the stock of the third corporation. Although the court declined to pass on whether or not a deficit carried over through the first foreclosure sale (330 F. 2d at 885), it held that the deficit of the second corporation was available to offset the earnings of the third corporation. If the Tenth Circuit's decision stands for the proposition that the deficit carried over because, even though the stockholders did not participate in the reorganization as stockholders, they were also bondholders and therefore were entitled to receive stock in the third corporation in exchange for their bonds, we would agree that there is a conflict in principle between the instant case and *El Pomar*.

However, the court in *El Pomar* several times suggested that it was basing its decision on the ground that the voluntary insolvency proceeding there in question did not reflect the substance of the transaction and that the common stockholders might actually have been entitled to a continuing interest in the third corporation *with respect to their stock* (rather than because they also owned bonds).[5] If

[5] Early in its opinion the court stated (330 F. 2d at 876):

> While technically the foreclosure on each reorganization wiped out the interests of unsecured creditors and stockholders of the respective predecessor corporation, that result did not actually occur as the reorganization was

this were indeed the substance of the transaction, the common stockholders would not have been entitled to a worthless stock deduction and would have been required to carry over the basis of both their stock and bonds in the second corporation as the basis of the stock they received in the third corporation. In such circumstances, *El Pomar* would not only be completely distinguishable from the instant case, but it would also be correct. Accordingly, while on the basis of the *El Pomar* opinion it is unclear whether the Tenth Circuit would have reached the same results as the court below on the facts of the instant case, it appears that the decision of the Tenth Circuit turned primarily upon its interpretation of the transaction before it rather than the application of different legal principles from those applied in the present case.[6]

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carried out. On each reorganization the successor corporation assumed and paid in full the indebtedness of the unsecured creditors, * * * and on the second reorganization all of the holders of stock in the predecessor corporation received stock in the successor corporation, thus preserving a continuity of stock ownership and the adjustment of the bond indebtedness * * * enhanced the value of the stockholders' equity.

A little later in the opinion the court suggested that the end result of the transaction before it was no different than if, instead of undergoing a reorganization, the corporation had simply issued additional common stock to its bondholders without extinguishing their interest as shareholders (330 F. 2d at 883–884). Finally, the court noted that "Here, only secured indebtedness of the bondholders was adjusted. Such adjustments increased the stockholders' equity" (330 F. 2d at 884).

[6] With the possible exception of *El Pomar*, every court that has considered the effect of a bankruptcy reorganization in which the stockholders were eliminated has concluded that a

For these reasons, the petition for a writ of certiorari should be denied.[7]

Respectfully submitted,

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MAY, 1966.

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pre-bankruptcy deficit may not be carried forward to offset post-bankruptcy accumulated earnings. *United States* v. *Kavanagh*, 308 F. 2d 824 (C.A. 8); *Banister* v. *United States*, 236 F. Supp. 972 (E.D. Mo.), appeal to C.A. 8 dismissed; *McCullough* v. *United States*, 344 F. 2d 383 (Ct. Cl.), certiorari denied, 382 U.S. 901; *Caspers* v. *Commissioner*, 44 T.C. 411. Indeed, where the stockholders have been eliminated, even a surplus in earnings is not carried forward. *Humpage* v. *Commissioner*, 17 T.C. 1625, acquiescence, 1962–2 Cum. Bull. 4.

[7] All courts would agree that if the transfer of assets from Old Missouri to New Missouri did not qualify as a tax-free reorganization under § 112 of the Revenue Act of 1936 (which was in force at the time of the instant transfer) there could be no basis for carrying over either a deficit or surplus from one corporation to another. Here, the district court held (Pet. App. 3–26) that the 1936 bankruptcy reorganization was not tax-free, but the court of appeals found it unnecessary to reach this question, holding that the deficit would not carry over even assuming *arguendo* that the 1936 transfer did constitute a non-taxable reorganization. If certiorari should be granted in the instant case and if the decision of the court of appeals should ultimately be reversed, the case should be remanded to permit the court of appeals to consider this alternative argument.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 1138

RICHARD H. DUNNING and BEULAH MARIE DUNNING,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITIONERS' REPLY BRIEF

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IN THE

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No. 1138

RICHARD H. DUNNING and BEULAH MARIE DUNNING,
Petitioners,

VS.

THE UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITIONERS' REPLY BRIEF

Respondent argues (1) that the issuance of warrants in exchange for the old common stock was of no significance and that the reorganization should be treated simply as if the common stock had been eliminated, and (2) that to permit the deficit to carry through the reorganization would produce a tax benefit akin to a double deduction. These arguments, closely inter-related, are both erroneous.

The warrants were of great economic benefit, significance and value to Middle West. The original Plan of Reorganization called for the issuance of only 2,399 warrants (R. 87). Objections sustained by the Court were made to this phase of the Plan as the result of which the Plan was modified to require the issuance of 13,000 warrants (R. 89). This was the only modification of the original Plan and its significance in terms of continuing control of the corporation is apparent when related to the fact that Middle West

received 30% of the new common stock and was by far the largest single shareholder.

Respondent errs in stating (Br. 5) that warrants do not constitute "stock or securities" subject to the non-recognition provisions of §112. *Helvering* v. *Southwest*,[1] cited by respondent, does not so hold, but holds merely that warrants are not the equivalent of "voting stock" within the meaning of clause (C) of § 112 (g) (1), a provision not involved in this case. Warrants have been consistently held to be securities.[2] Respondent cites no contrary authority.

The very fact of the issuance of the warrants is one factor requiring the transaction to be treated as an exchange rather than as an "elimination" of the common stock. There was an exchange of (common) stock for securities (warrants). More accurately, there was an exchange by one taxpayer of 75% of the old voting stock (common and voting preferred) plus promissory notes[3] for 30% of the new voting stock plus warrants. What was received was solely stock or securities and the loss (if any) upon the exchange was not permitted to be recognized under §§ 112 (b) (3) and 112 (b) (4) of the 1936 Revenue Act.

Although Middle West may have received new common stock "qua" its interest as creditor rather than "qua" its interest as a shareholder, that fact is irrelevant. Every Court of Appeals which has considered a similar question has so held.[4] Respondent concedes (Br. 7) the existence of

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1. 315 U.S. 194, 62 S. Ct. 546, 86 L. Ed. 789 (1942).

2. *E. P. Raymond* v. *Commissioner*, 37 B.T.A. 423 (1938); G.C.M. 2177; VI-2 Cum. Bull. 3501 (1927); and see *William H. Bateman* v. *Commissioner*, 40 T.C. 408 (1963).

3. Referred to by respondent as bonds, Br. 2, 5.

4. *Commissioner* v. *Huntzinger*, 137 F. 2d 128 (10th Cir. 1943); *Prairie du Chien-Marquette Bridge Co.* v. *Commissioner*, 142 F. 2d 624 (3rd Cir. 1943); *Seiberling Rubber Co.* v. *Commissioner*, 169 F. 2d 595 (6th Cir. 1948); and see *United States* v. *El Pomar Inv. Company*, 330 F. 2d 872 (10th Cir. 1964).

a conflict between Circuits if *El Pomar* stands for the proposition that the continuity test is satisfied and the deficit carries over where a stockholder who is also a creditor participates in the reorganization "qua" creditor but not "qua" stockholder. *El Pomar* stands for precisely that proposition.

For the first time respondent here contends that the reorganization produced a worthless stock deduction. Neither court below so held. In none of the cases relied upon by respondent was there reliance upon a worthless stock deduction theory. If the stock had been worthless no one would have bothered with an exchange. When the exchange occurred, Middle West (the only taxpayer who could conceivably claim any such deduction) was required to allocate its adjusted basis in the old common stock and promissory notes to the property received upon the exchange. Only upon the disposition of that property would gain or loss be recognized by Middle West.

Petitioners believe that the "double deduction" argument is erroneous. More important for present purposes, however, is the fact that if respondent's argument is accepted as legally sound, the conflict between the Circuits becomes even more apparent, because acceptance of that argument on the merits means that *Snider*[5] and *El Pomar*[6] (which petitioners believe are controlling) were incorrectly decided.

The petition should be granted.

Respectfully submitted,

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RICHARD H. BROWN,
Counsel for Petitioners.

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5. 224 F. 2d 165 (1st Cir. 1955).
6. *Supra*, footnote 4.